

August 28, 2009

City And County Of Honolulu, Hawaii; Water/Sewer

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City And County Of Honolulu, Hawaii; Water/Sewer

| Credit Profile | | |
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| US\$128.27 mil Wastewtr Sys Rev Bnds (Second Resolution) Junior ser 2009A due 07/01/2024 | | |
| Long Term Rating | A+/Stable | New |
| US\$67.66 mil Wastewtr Sys Rev Bnds (BABs/RZEDs) (First Resolution) Senior ser 2009C due 07/01/2019 | | |
| Long Term Rating | AA-/Stable | New |
| US\$36.765 mil Wastewtr Sys Rev Bnds (First Resolution) Senior ser 2009A due 07/01/2027 | | |
| Long Term Rating | AA-/Stable | New |
| US\$15.21 mil Wastewtr Sys Rev Bnds (First Resolution) Senior ser 2009B due 07/01/2019 | | |
| Long Term Rating | AA-/Stable | New |

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' long-term rating to the City and County of Honolulu, Hawaii's nearly \$120 million in senior lien wastewater revenue bonds, series 2009A, B, and C. At the same time, Standard & Poor's assigned its 'A+' long-term rating to Honolulu's \$128.27 million junior-lien wastewater revenue bonds, series 2009A. Finally, Standard & Poor's affirmed its 'AA-' underlying rating (SPUR) on Honolulu's senior-lien bonds and its 'A+' long-term rating on the city's junior lien bonds.

Rating factors include:

- The wastewater system's diverse and largely residential service area, comprising 72% of the population of Oahu, Hawaii's most populous island;
- Strong financial performance that has exceeded city council-adopted financial policies that include a debt service coverage target of no less than 1.60x on senior-lien debt and 1.25x on all revenue bond debt;
- Aggressive rate setting actions in support of capital spending requirements; and
- Good cash reserves, supported by a plan to maintain at least three months of operating expenses in reserve.

The above strengths should enable the department to manage a consent decree-driven capital plan that includes \$1.1 billion in financing through 2014.

The bonds are secured by a pledge of net operating revenues of the wastewater enterprise. There are both junior and senior liens that remain open and are expected to be used to finance the system's capital plan. The junior-lien debt is rated 'A+', with the lower rating reflecting the system's leverage position and its considerable additional debt requirements during the next five years.

The senior series 2009B bond proceeds will be used to refund outstanding debt, while series 2009A and C proceeds will provide financing for the system's capital plan. Series 2009C bonds may be issued as Build America Bonds or Recovery Zone Economic Development Bonds for which the city has indicated it would elect to receive a direct subsidy. The city has reported that it will remain obligated to pay 100% of principal and interest on the bonds and the debt service reserve. The junior lien series 2009A proceeds will be used to refund the city's outstanding junior

lien debt. The wastewater enterprise had \$714 million in senior-lien wastewater revenue debt and \$452 million in junior-lien wastewater revenue debt. There is a combined total of \$1.2 billion in wastewater revenue debt.

The system's very substantial capital needs, \$1.6 billion through 2014, continue to necessitate aggressive rate increases. In support of the system's financial requirements, the Honolulu City Council adopted a package of rate increases in 2005, with an additional incremental increase adopted in 2007, through fiscal 2011. Combined rate increases, adopted in 2005 and 2007, totaled 25% for fiscal 2008 and will decline to 18% for both fiscals 2009 and 2010, and 15% for fiscal 2011. The city projects it will need to continue double-digit rate increase through at least fiscal 2015 and has reported that it will likely adopt another multi-year rate package. Despite these increases, the average monthly residential bill is still what we consider to be affordable at \$59.93, based on fiscal 2010 rates for 7,480 gallons, as the city has a median household income of 125% of the nation for 2008. The city also plans to use additional debt financing and facility charges to fund the balance of its capital program.

Debt coverage was what we consider strong in fiscal 2008, excluding \$5.0 million of system facility charges, at 2.3x on the all revenue bonds and 3.7x on senior-lien bonds. If including debt service for the city's general obligation bonds, which it repays with system revenues, and state revolving fund loan the coverage would have been 1.9x. The city reports that the state revolving fund loan is subordinate to its junior lien bonds. The bond resolution's additional bonds coverage ratio on combined junior and senior coverage is 1.10x; the city expects this ratio to remain above 1.50x, excluding system facility charges, through fiscal 2014, based on the rate increases mentioned above.

The city's capital program currently assumes use of about \$1 billion of additional bonds and about \$105 million in state revolving fund loans, which would about double the current amount of debt outstanding. For fiscal 2010, the budget includes use of about \$18.6 million of cash for capital expenditures. Reserves, which are supported by policy, have been strong: At the end of fiscal 2009, there was a projected \$32.4 million in an operating reserve, equal to three months of operating expenses. If including the city's estimated unrestricted cash balances (\$53.2 million) day's cash would increase to 241 days.

Outlook

The stable outlook reflects our expectation that the city will be able to afford its very large capital plan by virtue of regular rate increases that should provide adequate revenue to support bonding plans. Critical to the maintenance of the rating will be the city's timely responsiveness of rate setting actions in the event that additional regulatory improvements are required.

Economy

With roughly 900,000 residents, or 72% of the state's total population, Honolulu is Hawaii's center for economy, government, transportation, finance, and education. The City and County of Honolulu includes the entire island of Oahu and a number of outlying islands. The area's large military presence has thus far helped smooth business cycles related to tourism, largely originating from Japan and the mainland. According to the Bureau of Labor Statistics, the preliminary June unemployment rate was 6.9%, up from 4.1% in the prior year. Although IHS Global Insight ranks the county's per capita income 45th in the nation, our median household effective buying income data for the county is what we consider strong at 125% of the nation for 2008.

Substantial Capital Needs

The wastewater system is faced with the challenges of upgrading, expanding, and rehabilitating parts of its collection and treatment systems, which have been vulnerable to breakages and overflow during peak wet weather conditions. Historically, Honolulu's main treatment facilities -- the Honouliuli and Sand Island plants -- have operated with a waiver from the U.S. Environmental Protection Agency (EPA) that had allowed it to operate with a primary treatment system instead of upgrading to a secondary treatment system. The most recent secondary treatment waiver was denied by Environmental Protection Agency and is being contested by the city. However, the city reported that it anticipates that the system would qualify for a waiver under the revised water quality standards that the state is in the process of amending.

The city has estimated that an upgrade to secondary treatment at the Honouliuli and Sand Island plants would cost \$400 million and \$800 million, respectively, which is not included in the city's \$2.9 billion, 20-year capital program. The city reports that it updates its long-range capital plan at least annually. The 20-year plan is driven, in part, by a 1995 consent decree to implement preventive maintenance as well as sewer replacement and rehab to reduce and prevent wastewater spills and bypasses from the collection system and pump stations. Also included in the plan is about \$300 million to address a stipulated order to repair and replace system mains related to a March 2006 spill of untreated wastewater into the Ala Wai Canal in Waikiki.

Operations

The Department of Environmental Services of the City and County of Honolulu was created in 1998 to manage the wastewater system. The system serves most of the city and county, (except for certain isolated areas that rely on private systems) with its nine wastewater treatment plants ranging from a current design capacity of .90 million gallons per day (mgd) to 86.1 mgd. Residential customers generate about 70% of the system's revenues, as reported by the city. The system serves a population of about 640,000 (143,000 customer accounts), or 74% of the city and county. About 70% of the system's revenues are generated from residential accounts. Due to relatively slow population growth on Oahu -- the city projects single-family residential equivalent units will grow about 0.3% annually through 2020 -- the city believes its current system capacity should be sufficient. The city expects most of the population growth to occur in east and west Mamala Bay. The system's largest plant, the Sand Island plant in East Mamala Bay basin, is currently using about 73% of its design capacity, and the city projects flow will exceed current capacity by 8% by 2020. All other plants are projected to remain within current capacity in 2020, according to the city.

Management policies adopted by city council have set minimum cash reserve levels and debt service coverage levels, such as a three-month operating reserve restricted for emergencies. Furthermore, the city has reported that rate setting is intended to generate sufficient net available revenues to provide a minimum coverage target of 1.6x senior-lien debt service and 1.25x junior-lien debt service.

Related Research

USPF Criteria: "Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds," Sept. 15, 2008

| Ratings Detail (As Of August 28, 2009) | | |
|---|------------------|----------|
| Honolulu City & Cnty wastewtr sys (Junior Ser) (2nd Bnd Res) (FSA) 2008A | | |
| <i>Unenhanced Rating</i> | A+(SPUR)/Stable | Affirmed |
| Honolulu City & Cnty wastewtr sys (Sr Series) (First Bond Resolution) ser 2007A wrap of insured (MBIA) (BHAC) (SEC MKT) | | |
| <i>Unenhanced Rating</i> | AA-(SPUR)/Stable | Affirmed |
| Honolulu City & Cnty wastewtr (wrap of insured) (FGIC & FSA) (SEC MKT) 2005A | | |
| <i>Unenhanced Rating</i> | AA-(SPUR)/Stable | Affirmed |
| Honolulu City & Cnty Wastewatr Sys Rev Bnds (First Resolution) Senior ser 2007C | | |
| <i>Long Term Rating</i> | AA-/Stable | Affirmed |
| Honolulu City & Cnty Wastewtr Sys Rev Bnds (second resolution) Junior ser 1998 & 2003 | | |
| <i>Long Term Rating</i> | A+/Stable | Affirmed |
| Honolulu City & Cnty sr lien wstwtr | | |
| <i>Unenhanced Rating</i> | AA-(SPUR)/Stable | Affirmed |
| Honolulu City & Cnty sr wstwtr | | |
| <i>Unenhanced Rating</i> | AA-(SPUR)/Stable | Affirmed |
| Many issues are enhanced by bond insurance. | | |

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